



July 22, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551

Re: Docket No. R-1417; RIN 7100-AD75

Dear Ms. Johnson,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Reserve Board's (FRB or Board) proposed rule to implement the Ability to Repay provisions of the Dodd-Frank Act. Moreover, CSBS looks forward to establishing a collaborative relationship with the Consumer Financial Protection Bureau as it assumes responsibility for Regulation Z and other consumer financial protection regulations.

Confirming that borrowers have the ability to repay a loan is the central decision in any judgment to extend credit. Because of the importance of this determination and abuses witnessed in the lead up to the financial crisis, CSBS believes creditors should consider and verify borrower information before extending a loan. In doing so, financial institutions should have the flexibility to determine the thresholds they believe appropriate for the risks and benefits of an individualized lending decision. Generally, the proposed rule captures the importance of this balance between considering repayment ability and ensuring flexibility in the credit decision. The basic framework proposed by the Federal Reserve should protect the financial system's economic and policy interests in making sure loans are properly underwritten.

I. REPAYMENT ABILITY

The logic behind both the statute and the proposed rule is sound: creditors should consider and verify a consumer's ability to repay a mortgage. Many states have recognized the policy value of ability to repay requirements, as many states have implemented laws that mirror various portions of the federal statute and proposed rule. Similarly, industry has recognized the economic value of ability to repay considerations. At the last meeting of the Federal Reserve's Consumer Advisory Council, industry representatives opined that the criteria laid out in the ability to repay requirements are part of their institution's regular lending decision making process. Further, these institutions are encouraged because the rule will hold all lenders to the same minimum standards. Combined, the policy and economic implications of making a reasonable determination as to whether a borrower can repay a mortgage are persuasive and should be implemented to ensure lending decisions are prudent.

CONFERENCE OF STATE BANK SUPERVISORS

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Accordingly, CSBS supports the requirement that a creditor make a reasonable and good faith determination that the consumer will have a reasonable ability to repay the loan according to its terms. CSBS also agrees this determination should be based on consideration of income or assets, current employment status, monthly payment amount, simultaneous loans, monthly payment for mortgage-related obligations, debt-to-income ratio or residual income, and credit history. CSBS has detail-specific recommendations about these factors in Section VI of this letter.

II. QUALIFIED MORTGAGE

A. Presumption of Compliance

Because of the importance of a reasonable determination of repayment ability, a presumption that a creditor has considered a borrower's ability to repay must be meaningful. The "Qualified Mortgage," or QM, has been designated as the embodiment of said presumption. Accordingly, CSBS supports defining a Qualified Mortgage as a mortgage that:

- Limits risky features, including no negative amortization, interest only payments, or balloon payments
- Does not exceed 30 years
- Generally does not have points and fees exceeding 3%
- Is underwritten with a fully amortizing payment schedule
- Has repayment ability determinations based on the maximum interest rate in the first five years after consummation
- Includes consideration and verification of income or assets
- Includes consideration of mortgage-related obligations
- Includes consideration and verification of:
 - Employment status
 - Simultaneous loans
 - Current debt obligations
 - Debt-to-Income ratio or residual income
 - Credit history

If a creditor has originated a mortgage meeting these characteristics, then the creditor should be given a rebuttable presumption of compliance with the ability to repay standards it would otherwise be required to meet. While this presumption standard provides less legal protection than the Safe Harbor proposed by the Federal Reserve Board, it encourages all institutions to consider repayment factors that are part of a sound underwriting process. A creditor should not be granted blanket protection from a foreclosure defense of an ability to repay violation if the creditor did not consider and verify crucial information such as employment status and credit history.

It is important to remember that a mortgage that does not meet these Qualified Mortgage standards can still be originated after an ability to repay determination. To that end, CSBS believes a mortgage carrying the Qualified Mortgage presumption of compliance should be a strong indication that a reasonable ability to repay determination has been made, not an exception that can be used to escape the consideration of crucial underwriting criteria. To be

presumed to have made a reasonable determination of repayment ability should have as a prerequisite the consideration of employment status, simultaneous loans, current debt obligations, debt-to-income ratios or residual income, and credit history.

B. Individualized Lending Decisions

While it is important to consider these factors, CSBS supports the flexibility the proposed rule gives to lenders seeking to originate a Qualified Mortgage. The proposed rule does not set thresholds or limits on repayment ability factors. Instead, creditors must consider these factors and are held to a good faith standard. This means individualized determinations can be made based on each borrower, local markets, and the risk tolerance of each creditor.

III. THE QUALIFIED MORTGAGE AND THE QUALIFIED RESIDENTIAL MORTGAGE

A. Consistency between QM and QRM

The Dodd-Frank Act states that the Qualified Residential Mortgage (QRM) can be “no broader than” the Qualified Mortgage. Dodd-Frank also requires the federal agencies to consider the documentation of financial resources relied upon to qualify the mortgagor when defining the QRM. The agencies’ proposed QRM outlines specific factors to be considered in the QRM not specifically outlined in the QM portion of the statute. These factors are the same as those in the proposed QM Alternative 2, *Rebuttable Presumption of Compliance*, including employment, simultaneous loans, current debt obligations, debt-to-income ratios, and credit history. CSBS believes these factors should be included in the definition of both the QM and QRM, as they represent the appropriate factors to consider for determining ability to repay and risk of default.

Aligning the QRM and QM credit qualification criteria will streamline the origination process and satisfy the statute’s requirement that the QRM is no broader than the QM. More importantly, it satisfies the policy goals of both designations. The Qualified Residential Mortgage should have the highest underwriting standards to be exempt from risk retention requirements. To meet this standard, the QRM must include consideration of each of the ability to repay standards. The Qualified Mortgage should represent compliance with the requirement to consider and verify a consumer’s ability to repay a mortgage. To meet this standard, the QM should include consideration of each of the ability to repay standards.

The only factors proposed in the QRM that have not been included in the proposed QM are the loan-to-value ratio (LTV) and servicing requirements. CSBS does not believe servicing requirements should be included in the QRM definition because it does not reflect the quality of the mortgage. Further, servicing standards need to be developed in a holistic, deliberative manner, not on a product-by-product basis. Removing servicing standards from QRM requirements would ensure the two characteristic sets remain consistent. Conversely, CSBS believes that including LTV in the factors for a creditor to consider to qualify a mortgage as a QM would provide some repayment ability guidance and keep the origination process streamlined. LTV gives creditors a solid understanding of the credit sought by borrowers, and is a factor performed intrinsically when not performed explicitly. Creditors consider down payments as part of their lending decision, and to include it in both definitions would promote consistency in documentation of the lending decision.

B. Thresholds

As noted above, CSBS supports a definition of the QM where lenders are given discretion to determine their individualized lending decisions. Ability to repay considerations are precisely that—considerations. To set a minimum standard for every mortgage presumed to be compliant with ability to repay requirements would stifle a lender’s ability to make business decisions as well as severely limit credit availability. However, thresholds are appropriate for the Qualified Residential Mortgage. The QRM is a mortgage representing a low enough risk of default that risk can be passed on without “skin in the game.” This requires a minimum standard to be established through thresholds designed to reflect a historically low risk of default. The proposed QRM rule properly sets out this standard, and CSBS believes the proposed thresholds are appropriate to designate mortgages that are exempt from risk retention if securitized and sold to investors.

The difference between thresholds in the QRM and QM underscores the difference in the designations carried by these mortgages. While a QM is simply a mortgage presumed to have been originated after the consideration of repayment ability, the QRM represents a mortgage investors and regulators can trust as not requiring risk retention by the originator to ensure credit quality. Accordingly, the QM must include consideration of credit criteria, whereas the QRM must prove that the criteria considered are high quality.

IV. BALLOON QUALIFIED MORTGAGE

CSBS appreciates the Board’s acknowledgment that community banks originate balloon payment loans to hedge against interest rate risk. As noted in the discussion, community banks hold balloon payment loans in portfolio virtually without exception because of the lack of an outlet to the secondary market. With proper underwriting, use of this product is driven by interest rate risk, which institutions bear along with the heightened credit risk associated with a balloon payment within their portfolio. Accordingly, the exception for balloon qualified mortgages should be extended to all institutions that portfolio this kind of product to mitigate credit risk.

Institutions that portfolio mortgage loans have a greater incentive to ensure a borrower’s ability to repay and fund the total cost of homeownership. This fundamental understanding of portfolio lending needs to be considered as rules and standards are determined. Federal policy should not significantly alter the economics and desirability for traditional banks to make residential mortgage loans in their communities.

Further compounding the shortcomings of this exemption for institutions that portfolio balloon mortgages is the Board’s designation of “rural and underserved” areas. As was the case in the proposed Jumbo Escrow rule exemption,¹ the Urban Influence Code test does not adequately provide for the full scope of institutions this exception was designed to serve. The proposed designation of rural counties does not account for the differences in county structures throughout the country and undermines the lending ability of many community banks that portfolio their loans. The rural and underserved test must be revisited to ensure that all institutions that

¹ CSBS’s comment letter regarding these proposed changes to Regulation Z is available at <http://www.csbs.org/regulatory/policy/Documents/CSBSCommentLetterToFRBOnHigher-PricedLoanEscrowRequirements.pdf>.

internalize the credit risk of appropriately underwritten balloon payment mortgages are able to do so in order to stay engaged in the mortgage lending business.

Because of the heightened consumer protection issues associated with balloon mortgages, the regulation implementing the statute's exemption for the qualified mortgage with balloon payments should have sufficient repayment ability standards. CSBS supports the Board's five-year minimum loan term. This is an appropriate floor for responsible balloon products that community banks can utilize to extend credit where interest rate risk would otherwise prohibit such loans. CSBS also supports the Board's decision to exclude from the definition of qualified balloon mortgages those that include principal repayment deferral resulting from interest-only payment structures. This is an appropriate narrowing to ensure that balloon payment products are used by those institutions that appropriately utilize the product to mitigate interest rate risk.

V. RECORD RETENTION REQUIREMENTS

CSBS would like to note a potential problem with the Dodd-Frank remedies for ability to repay violations and record retention requirements. While jurisdictions differ over appropriate record retention requirements, there is a limit to the practicality of retaining the documents relied upon to make a reasonable determination of ability to repay. However, there is no time limit on the Dodd-Frank §1413 Defense to Foreclosure remedy. Section 1413 states,

when a creditor, assignee, or other holder of a residential mortgage loan or anyone acting on behalf of such creditor, assignee, or holder, initiates a judicial or nonjudicial foreclosure of the residential mortgage loan, or any other action to collect the debt in connection with such loan, a consumer may assert a violation by a creditor of [steering incentive prohibitions] or of [ability to repay requirements], as a matter of defense by recoupment or set off **without regard for the time limit on a private action for damages under subsection (e).**

This raises a significant question: for how long should institutions retain records considering the documents could be called into question years after the mortgage is consummated or even foreclosed upon? A proper balance needs to be struck to make record retention affordable and legally effective. CSBS would be glad to participate in any regulatory effort to address this issue.

VI. DETAILED COMMENTS ON PROPOSED SECTION 226.43

CSBS recognizes and appreciates that the Federal Reserve put tremendous effort into the details of their proposed rule. To gain appropriate feedback from across the country, state regulators convened throughout the comment period to perform a high-touch review of the proposal's details. We offer the Federal Reserve the following feedback, and hope the states' experiences with Regulation Z can help the Consumer Financial Protection Bureau as it promulgates the final rule.

§ 43(a) Scope

The proposed scope – “any consumer credit transaction that is secured by a dwelling” other than a home equity line of credit, timeshare, reverse mortgages, and temporary or bridge loans – is too

broad. There are many transactions where ability to repay is not a significant concern and should be left to an institution's business judgment such as vacation homes and investment properties. Accordingly, CSBS recommends limiting covered transactions to owner-occupied primary residences.

§ 43(b) Definitions

Fully Indexed Rate

- Multiple Margins – State regulators are unaware of any loan products possessing more than one margin that may apply over the loan term, but support the FRB's use of the maximum margin to prevent any abuses of rule technicalities.
- Step Rate Mortgages – CSBS believes using the maximum interest rate on a step-rate mortgage may be overly restrictive. The maximum interest rate that occurs in the first 5 years is an appropriate time horizon, subject to limits on the subsequent interest rate increase.

Higher-priced covered transaction – CSBS appreciates that the proposed definition is consistent with previous definitions of “higher-priced covered transaction.” However, because lending markets vary significantly across the country, the Federal Reserve should consider raising the threshold to alleviate standards that may be too low for institutions subject to higher priced market conditions and higher costs. Institutions should know the suitable threshold for their local market; therefore, a higher threshold is appropriate to provide flexibility.

Recast – CSBS believes it is helpful to have a single definition for the expiration of introductory periods and/or rates.

§43(c) Repayment Ability

Simultaneous Loans

- Verification – promissory notes are appropriate documentation for verifying simultaneous loans.
- Purchase vs. Nonpurchase – simultaneous loans should be considered for nonpurchase transactions to prevent loopholes.

Mortgage Related Obligations – verification using HUD-1 forms is acceptable because there is a legal obligation to complete the HUD-1 accurately.

Current Debt Obligations – creditors should be given flexibility in the consideration and verification of current debt obligations.

- Verification – the verification standards used to determine “current debt obligations” must be flexible. Paralleling HOEPA is appropriate.
- Credit Report Omissions – where a current debt obligation is listed on an application, but not listed in a credit report, the regulation or commentary should encourage verification, but not require verification because the fact that the obligation was disclosed is an indication of trustworthiness.
- Obligations almost paid off – it is fair to limit the consideration of current debt obligations to obligations that recur beyond a short-term time frame. Any guidance

should preserve some flexibility for creditors to assess such obligations, as long as the borrower is able to repay during the short-term time frame.

- Forbearance or Deferral – these obligations should be considered, but creditors should be given flexibility.
- Joint Applicants – all rules used for single-party borrowers should apply to joint applicants.

Debt-to-Income Ratio – CSBS supports the requirement that creditors consider the consumer’s monthly debt-to-income ratio or residual income. By requiring consideration without mandating a threshold, creditors will have the flexibility needed to determine whether a borrower can repay.

Credit History – CSBS supports the requirement that creditors look to widely accepted governmental and nongovernmental underwriting standards to define and verify “credit history.” This requirement must be broad enough to give creditors flexibility.

Verification Using Third-Party Records – there are occasions where the creditor must have a good faith belief that documents are reliable. For self-employed borrowers, the latest income tax statements are generally more reliable, as they show a pattern of income and are official government documents.

Verification of Income or Assets – CSBS believes the FRB’s rationale is sound in implementing the alternative methods of third-party income documentation requirements without the phrase “quickly and effectively.” Instead, it is appropriate to require third-party records that are reasonably reliable and provide examples of such records. However, CSBS would like to know what examples the FRB would put forward for these types of records, and is willing to work with the CFPB to determine appropriate records.

Payment Calculation

- Safe Harbor – CSBS supports the establishment of a safe harbor for creditors using the largest scheduled payment that can occur during the loan term to determine the consumer’s ability to repay to facilitate compliance.
- “Substantially Equal” Monthly Payment – a 1% variance threshold for monthly payments to be considered substantially equal is insufficient. If the monthly variance is calculated by the number of days in a month, the payment could vary by approximately 3% depending on the month. Accordingly, if a variance threshold is used, it should be 5% to ensure all de minimus variables are considered.
- “Loan amount or outstanding principal balance” – it is reasonable for a creditor to calculate the monthly payment using the fully indexed rate based on the outstanding principal balance as of the date the fully indexed rate takes effect under the loan’s terms, instead of the loan amount at consummation.
- Prime Balloon Loans – determining a consumer’s ability to repay a loan with a balloon payment using the maximum payment scheduled during the first five years for a prime loan is appropriate.
- Negative Amortization Loans – creditors should be required to use the largest payment scheduled when determining the consumer’s ability to repay a negative amortization loan.

- Simultaneous Loans – requiring creditors to calculate the payment for simultaneous HELOCs based on the amount of funds to be drawn by the consumer at consummation is logical, but may lead to abuse. Accordingly, if drawing any amount of the HELOC at closing is necessary to complete a deal, then the entire amount of the line should be considered.

§43(d) Refinancing of Non-Standard Mortgages

Overview – CSBS believes a refinancing designed to put a borrower in a higher quality “standard mortgage” before the existing low quality mortgage resets should be given greater deference. It is sound policy to encourage refinancing where it protects both the economic interest of the creditor and the financial health of the consumer.

Scope

- Requirement that the Creditor is the Current Holder – CSBS recommends a holding period of 2 years to prevent abuse of the exemption from ability to repay requirements for a refinancing.
- Requirement that a Monthly Payment for the Standard Mortgage is Materially Lower – CSBS agrees a 10% payment reduction should be considered “materially lower.” Where the payment change is less than 10%, additional scrutiny is required.

Standard Mortgage

- CSBS strongly supports the requirement that the interest rate be fixed for the first five years of the standard mortgage. As the FRB has reasoned, this will ensure that consumers refinance into stable products for a sustainable period of time. Further, this permits 5/1 ARMs.
- Loan proceeds used for limited purposes – CSBS agrees proceeds should be restricted to paying off outstanding principal balance on a non-standard loan and closing costs, with the exception of known home repair needs. This exception should require verified estimates in advance to ensure that the proceeds are used for required home repairs only.

Likely Default – CSBS agrees there can be no quantified standard for the definition of “likely default.” Institutions must use sound judgment, and regulators must provide responsible oversight to ensure that abuses are not occurring through the refinancing of non-standard mortgage exception to ability to repay requirements.

§43(e) Qualified Mortgage

Limits on Periodic Payments – to prevent circumvention of the limits placed on periodic payments, the maximum interest rate can be tied to an index.

Term – extending the term of a loan beyond 30 years is appropriate in modifications. There are also many areas in the country that benefit from loan terms in excess of 30 years, which the FRB can determine using housing price indices.

Maximum Interest Rate in First Five Years – the FRB’s reasoning regarding starting at consummation versus the first payment date is sound, as products can be structured to reset

outside of this parameter regardless of the rule. Any effective way to prevent such purposely structured products would require legislation.

Debt-to-Income Ratios (DTI) – debt-to-income ratios are useful determinants of ability to repay, but should be used flexibly. From a regulatory perspective, it would be useful to have examination considerations to look towards for guidance. Any such guidance must include mitigating factors for creditors to consider when operating outside of standard parameters. For example, creditors lending outside of typical DTI standards can rely upon other assets or the fact that a borrower has a high income. A 50% DTI ratio is not generally an issue if the borrower earns \$2 million annually.

CSBS applauds the Federal Reserve's efforts to conduct outreach to explore the wide range of underwriting guidelines for debt-to-income ratios based on product type, whether creditors used manual or automated underwriting, and special considerations for high- and low-income borrowers. By engaging in outreach programs, federal and State regulators can better understand the individualized determinations necessary in credit decisions across different markets, products, and institution classes.

CONCLUSION

The basics of lending decisions and the requirements outlined in the ability to repay statute and proposed rule are not mutually exclusive. In implementing and enforcing these requirements, regulators must be mindful of the business judgment of lenders and the individualized circumstances present in every extension of credit. Ability to repay requirements ensure the basic tenants of lending are followed, which should provide an even playing field for creditors of all shapes and sizes. CSBS thanks the Federal Reserve for laying out a well-reasoned approach to these requirements, and looks forward to working with the CFPB to ensure that the final rules provide the framework required to allow lenders to make prudent decisions based on the basic set of criteria required for every mortgage origination.

Sincerely,

A handwritten signature in black ink, reading "Neil Milner". The signature is written in a cursive, flowing style.

Neil Milner
President & CEO